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COMMISSION OF THE EUROPEAN COMMUNITIES

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**COMMISSION STAFF WORKING DOCUMENT**

*accompanying the*

Proposal for a

**DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL**

**on the coordination of laws, regulations and administrative provisions relating to  
undertakings for collective investment in transferable securities (UCITS)**

**EXECUTIVE SUMMARY TO THE IMPACT ASSESSMENT REPORT**

{COM(2008) 458 final}  
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## COMMISSION STAFF WORKING DOCUMENT

### EXECUTIVE SUMMARY TO THE IMPACT ASSESSMENT REPORT

#### 1. REVIEWING THE UCITS DIRECTIVE

##### The UCITS Directive

The Undertakings for Collective Investment in Transferable Securities (UCITS) Directive<sup>1</sup> was adopted in 1985. It aimed at creating a single market for investment funds that would enhance the business and investment opportunities for both industry and investors. The Directive defined a set of requirements which investment funds needed to comply with in order to be eligible for cross-border marketing. Their main objective was to ensure high levels of investor protection. The Directive also introduced the first financial services passport.

The UCITS Directive has been key to the development of the European fund market. In June 2007, UCITS assets under management amounted to € 6tr. UCITS represent about 75% of the EU investment fund market. Despite this positive evolution, it became evident that the Directive was excessively constraining and prevented fund managers and administrators from fully exploiting their development possibilities. Amendments in 2001 enlarged the investment powers available to UCITS managers but did not tackle bottlenecks to industry efficiency.

The review of the UCITS legislative framework has been a three-stage process (please see figure 1). In 2005, the Commission **Green Paper** on investment funds<sup>2</sup> launched a public debate on the need for EU level action and its scope. Both Commission services' research and stakeholders' consultation led to the same conclusion: focus should be on modifying the Directive to remove remaining barriers to market access and to allow fund industry to organise fund management and administration more efficiently.

These reflections were taken one step further in the **White Paper** on investment funds<sup>3</sup> and its impact assessment (WPIA). This analysed a series of possible adjustments both to enhance the efficiency of the fund industry's supply side and to strengthen its demand side. In some instances, the WPIA report concluded that EU level action did not appear to be sufficiently justified. Industry-led or national initiatives were considered sufficient or preferable. In other cases, non-legislative measures were considered to be the most cost-effective option. Finally, the analysis concluded that legislative changes were required in certain cases. Accordingly, the White Paper announced amendments to the UCITS Directive in relation to five issues: 1) notification procedure, 2) fund mergers, 3) asset pooling, 4) management company passport and 5) simplified prospectus.

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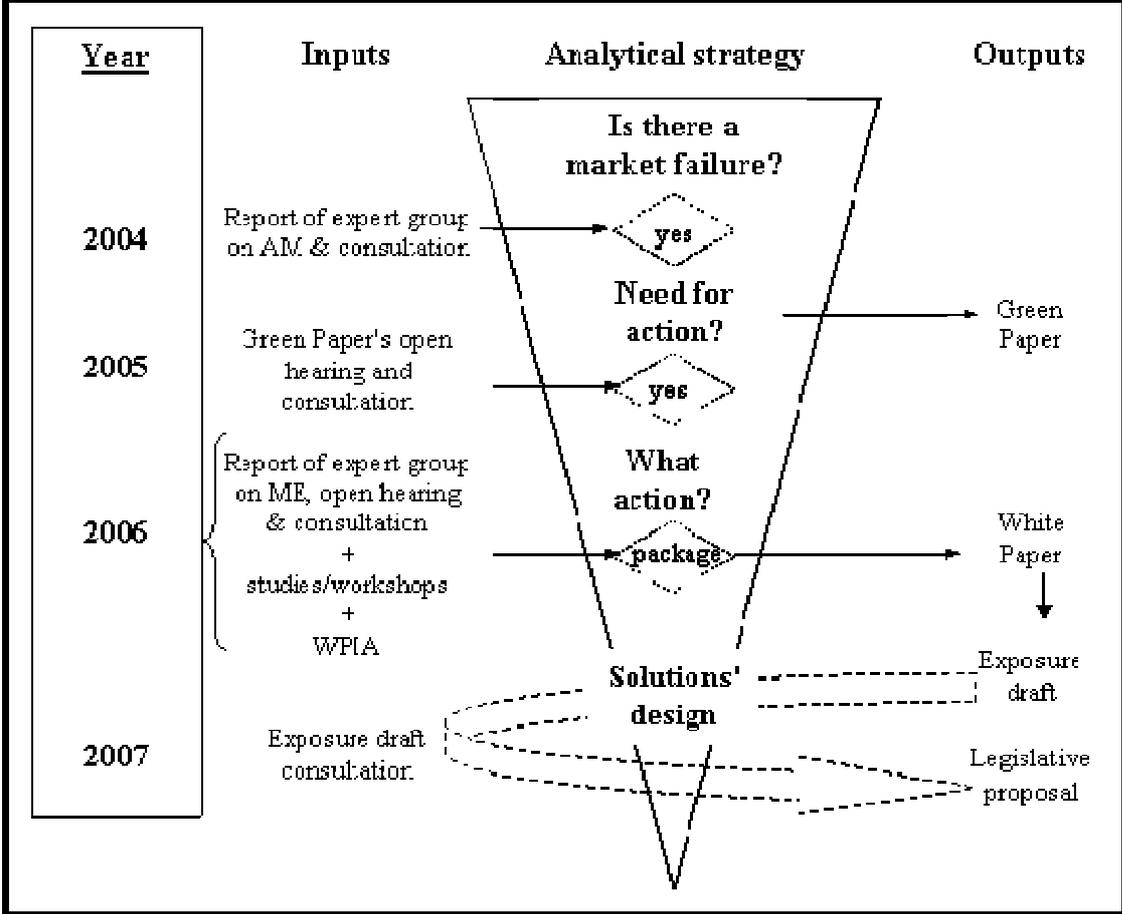
<sup>1</sup> Directive 85/611/EEC of 20 December 1985 amended, inter alia, by Directives 2001/107/EC and 2001/108/EC of 21 January 2002, both also called UCITS III directives.

<sup>2</sup> Green Paper on enhancing the European framework for investment funds, COM(2005) 314 final, 12<sup>th</sup> July 2005.

<sup>3</sup> White Paper on the enhancing the single market framework for investment funds, COM (2006) 686 final, 15<sup>th</sup> November 2006.

On 22<sup>nd</sup> March 2007, DG Markt published an 'exposure draft' as a basis for public consultation on the form of those legislative changes. The purpose of the consultation was to gather feedback on the design of the measures announced by the White Paper. Respondents' contributions have been an important and valuable input to the analysis developed in the legislative proposal IA report.

**Figure 1: The UCITS framework review process**



**2. IDENTIFIED PROBLEMS REQUIRING A CHANGE TO THE UCITS DIRECTIVE**

2.1. Barriers to marketing funds in other Member States. The notification procedure introduced by the 1985 Directive is often long and cumbersome. Host regulator's requirements often exceed those in the Directive and the two-month limit is not always respected. As a result, the procedure has been compared to a second authorisation of the fund. Estimated direct annual costs for the fund industry for maintaining notification amount to €25 million (in addition to more than €20 million for the initial notification)<sup>4</sup>. More significant are the opportunity costs related to the delays in getting products to the market.

Accordingly, the WPIA recommended that amendments to the Directive should a) reduce notification delays, b) replace the current procedure by a regulator-to-

<sup>4</sup> "A Harmonised, Simplified Approach to UCITS Registration", EFAMA and IMA, April 2005.

regulator communication exchange and c) clarify each Member State (MS) authority role and responsibilities.

- 2.2. Proliferation of funds of a sub-optimal size. The European fund market landscape is characterised by a high number of small funds. At the end of 2006, 54% of European funds managed less than € 50 million in assets. The average European fund is more than five times smaller than its American counterpart. Managing large ranges of small funds is costly. It impedes the exploitation of economies of scale and increases costs. Estimated annual savings amount to up to € 6bn<sup>5</sup>.

The WPIA concluded that two measures would allow the fund industry to fully exploit potential economies of scale: 1) a legislative framework for (cross-border) fund mergers and 2) the possibility for UCITS to engage in entity pooling.

- 2.3. Lack of flexibility in organising the industry value-chain. Although 2001 amendments introduced a passport for the management company for corporate UCITS, it is currently not possible for management companies to manage a UCITS in another MS. Ambiguities in the Directive text and split supervision concerns have deprived the relevant 2001 provisions of their effect. As a result, fund groups are obliged to establish a fully-fledged management company in each MS where they wish to base a fund range.

The WPIA identified a prima facie case for introducing an operational passport. The introduction of the management company passport was conditional on finding cost-effective and operational solutions to provide effective supervision and enforcement of remotely managed funds.

- 2.4. An ineffective simplified prospectus. Despite the clarification provided by the Commission Recommendation in 2004<sup>6</sup>, the simplified prospectus has failed in its mission to provide investors with a useful tool on which to base their investment decisions. The simplified prospectus is too long and complex and, thus of limited value to the investors. At the same time the production of the simplified prospectus is relatively costly and time-consuming for the industry.

The WPIA put forward pursuing a new approach for the simplified prospectus, i.e. changes to the Directive focusing on the core principles for investor disclosures and possibility to define the details (e.g. format and content) through implementing measures.

### **3. DESIGNING THE WHITE PAPER LEGISLATIVE CHANGES**

In designing the new provisions, a number of possibilities have been considered. These options have been assessed against the criteria of efficiency, market integration and investor protection. These impacts are summarised in the table in annex.

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<sup>5</sup> "Building an Integrated European Fund Management Industry: cross-border mergers of funds, a quick win?", Invesco, January 2005

<sup>6</sup> Commission Recommendation 2004/384/EC of 27 April 2004 on some contents of the simplified prospectus as provided for in Schedule C of Annex I to Council Directive 85/611/EEC.

### **3.1. Addressing barriers to marketing funds in other MS**

#### *The notification procedure*

The exposure draft presented an overhaul of the notification procedure. It envisaged a direct transmission from the home regulator to the host regulator. The authorities of a host MS would not be able to oppose the marketing of duly authorised UCITS in the host Member State.

Responses to the exposure draft consultation were generally supportive of the proposals but expressed some concerns regarding the possibility for host authorities to enforce non harmonised rules on advertising. In finalising proposals Commission services have compared two possible options:

1) maintain host MS regulator ex-ante<sup>7</sup> verification of the UCITS marketing arrangements but reducing the period available for that verification;

2) allow immediate marketing of UCITS in the host market: host MS regulator's checks takes then place ex-post on an on-going basis – focussed heavily on local distribution channels.

The analysis carried out shows that the first option (ex-ante verification) would not significantly improve the current situation. The costs linked to the notification procedure would not diminish perceptibly. Uncertainty about UCITS time-to-market in the host MS would also remain. The notification procedure would then continue to act as an entry barrier. This will reduce the fund offer available to investors and hold back competition forces (as well as their positive effect on the fund charges paid by investors). Accordingly, only a decisive simplification of the procedure would produce a significant positive effect. This is achieved by the second option. It has been argued that eliminating host MS regulator's ex-ante controls could undermine investor protection. The analysis of impacts however concludes that this risk is fairly small.

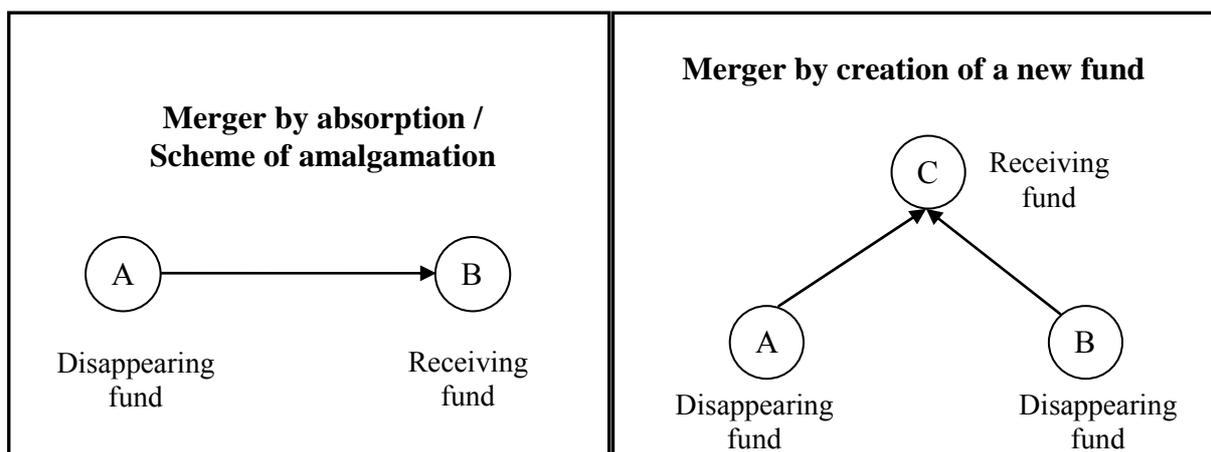
### **3.2. Addressing the proliferation of funds of a small size**

#### a) *Fund mergers*

The exposure draft presented stakeholders with a preliminary design of an EU framework for UCITS mergers. The proposed framework would cover a series of commonly used merger techniques (please see graphs below) and would apply to both domestic and cross-border mergers. A set of requirements for the regulatory approval of the merger and specific investor protection provisions were also put forward.

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<sup>7</sup> That is, before the UCITS has been placed into the market of the host MS. (Likewise, 'ex-post' controls take place once the UCITS is marketed in the host MS).



The proposed approach was generally supported by all categories of stakeholder. However, some investor protection concerns were voiced in relation to the proposed investor rights. Accordingly the IA has analysed two options:

- 1) Information on the merger is only provided to the investors of the disappearing fund
- 2) Information on the merger is provided to both investors of the disappearing and of the receiving funds

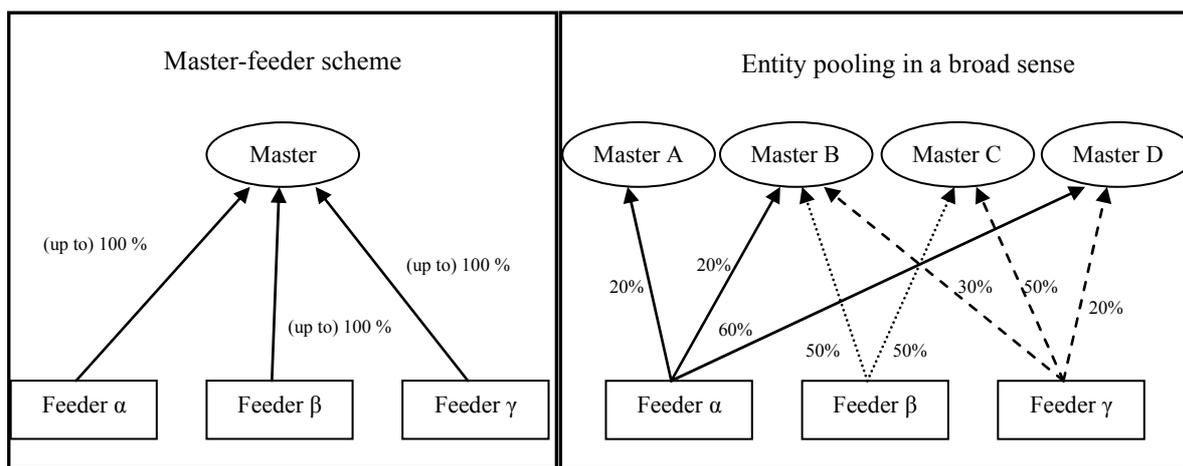
The analysis of impacts concludes that none of these options are fully satisfactory from both efficiency and investor protection point of view. The first option minimises the administrative costs for the industry but gives rise to some investor protection concerns; the second minimises investor protection risks but is overly onerous. The analysis considers a combination of both options as the most advisable policy choice. This could imply that information is systematically provided to investors of the disappearing fund but, in certain cases, also to investors of the receiving fund. It is for example recommended that the regulator responsible for deciding on the merger proposal would assess the potential impact of the merger on the investors of the receiving fund and decide, if appropriate, that these investors be also informed.

b) Asset pooling

The WPIA report identified two possible pooling techniques: entity pooling in a broad sense and so-called 'master-feeder' structures. These concepts are described graphically below.

The exposure draft presented an outline of the changes to the UCITS Directive necessary to provide a framework for entity pooling. On the basis of a preliminary assessment of impacts, the exposure draft proposals concentrated on master-feeder structures. Respondents found the proposed framework rather prescriptive. As regards to the entity pooling technique selected, a majority of respondents supported this choice. There was however a number of contributors that invited the Commission to consider the introduction of a framework for entity pooling in a broad sense. The analysis of impacts has therefore focused on the following options:

- 1) Allowing entity pooling in a broad sense.
- 2) Allowing master-feeder structures.



The possibility to use entity pooling in a broad sense could bring important advantages to industry players. Flexibility to tailor feeder funds' composition would allow fund promoters to adapt their fund ranges to changing trends and investors' demands. However, the Commission considers that introduction of this possibility would be equivalent to a relaxation of the existing provisions for UCITS funds of funds<sup>8</sup>. Relaxation of these diversification requirements could have significant unintended consequences for investors. The IA analysis therefore concludes that the simple master-feeder option is to be preferred both in terms of efficiency and investor protection.

### 3.3. Addressing the lack of organisational flexibility

#### The Management Company Passport

The exposure draft tried to strike the balance between a comprehensive Management Company (MC) passport and supervisory concerns. The proposed framework included provisions to ensure a minimum of substance in the fund domicile and to enhance the supervisors' cooperation mechanisms.

Contrary to the other four topics, responses to the exposure draft consultation expressed quite divergent views regarding the proposal. Industry respondents voiced their disappointment regarding the proposed scope of the passport. Others, mainly national authorities, considered that the proposed approach did not provide a clear definition of regulators' respective responsibilities. Given the fundamental questions raised during the consultation, the analysis of impacts has concentrated on the following options:

- 1) Maintain the status quo (i.e. do nothing)
- 2) Make the MC passport (MCP) work for corporate funds and extend it to contractual funds
- 3) Make the MCP work for corporate funds

Commission's analysis suggests that the absence of a MCP does deprive the industry of flexibility in domiciling functions and of costs savings. Work since the exposure draft has concentrated on the design of provisions which avoid regulatory gaps, uncertainty or overload

<sup>8</sup> A fund of funds is a fund whose portfolio is basically made of funds (and liquidity). The UCITS Directive includes a set of rules that UCITS fund of funds need to comply with, notably the obligation to invest at least in 5 funds.

by 1) clarifying the respective responsibilities of fund and MC supervisor, 2) providing mechanisms to allow the fund supervisor and depositary with means to monitor and enforce compliance with the rules in force in the fund domicile and 3) ensuring that the MC and its supervisor provide all necessary support to the fund supervisor and depositary.

Work on the design of effective provisions reveals that this would:

- Entail extensive information exchange and reporting obligations between management company, fund supervisor, management company supervisor, fund administrator and depositary.
- Leave open many concerns about respective responsibilities – fund supervisor and depositary would be largely dependent on the management company and the management company supervisor to discharge their obligations. Concerns exist that incentives and responsibilities would not be properly aligned
- Enforcement concern remains, particularly as regards contractual funds. As these are the only existing UCITS form in 13 MS, the economic impact of the management company passport for corporate funds appears limited.

The IA therefore concludes that the type of provisions needed to provide a MCP would entail extensive bureaucracy and administrative costs. They would not fully dispel supervisory risks associated with cross-border fund management. Potential drawbacks are considered to outweigh the expected benefits. The Commission therefore proposes not to change the provisions of the Directive in this regard but maintain the status quo whereby fund managers undertake cross-border management through delegation-based solutions. The Commission intends to ask CESR to provide advice on safe, efficient and cost effective solutions that can provide confidence in respect of a range of supervisory and risk management issues.

### **3.4. Addressing the Simplified Prospectus ineffectiveness**

#### Key investor information

The WPIA put forward a list of potential changes relating to the length, the content and even the name of the Simplified Prospectus (considered by some as confusing). On that basis, the exposure draft presented a new approach to investors' disclosures: the key investor information (KII) concept. It put forward the idea of a fair, clear and not misleading set of information. The proposed framework was generally welcomed by stakeholders. Nevertheless, respondents expressed different views regarding the fact that the proposal did not require the KII to be presented in a single document. The analysis therefore focuses on the impacts of two possible options:

- 1) KII is provided in the form of building blocks not necessarily embodied in one single document.
- 2) KII is provided as a single stand-alone document

The building block approach would allow for greater flexibility regarding the presentation of the information. It would then be possible to adapt disclosures to the type of investor and/or to the distribution channels and methods used. However, a single document would most probably be simpler to use by investors. Investors will be also able to compare between

products. This ability to compare among funds should, in the medium term, encourage competition forces and therefore put pressure on prices (fees). Additionally, from a compliance costs point of view, the building block approach should imply higher adjustment costs for the industry. Thus, a single stand-alone document appears to be the option that complies better with the objectives of investor protection and efficiency.

#### **4. THE PROPOSED PACKAGE OF MEASURES**

The IA therefore recommends action to:

- (1) Radically simplify the notification procedure
- (2) Facilitate fund mergers
- (3) Allow master-feeder (pooling) structures
- (4) Extensively overhaul the simplified prospectus

The economic savings to be expected from the proposed measures take the form of both static cost savings for industry and investors and dynamic benefits linked to competition and productivity gains. Several euro billion could be saved annually in direct efficiency gains. These will flow gradually to investors; some in the form of greater performances (due to lower fund costs), others, in the form of lower fees pushed by a greater competition and facilitated by investors' possibility to compare between funds. Greater flexibility to organise and conduct the fund business and simplified procedures should create new business opportunities and, by reducing administrative burden, increase the fund industry's competitiveness vis-à-vis that of other products and markets. A more integrated investment fund market will also offer the European investor an enlarged choice of better performing funds. Preserving the high levels of investor protection already offered by UCITS will reinforce their attractiveness within and beyond EU borders. Over the long run, these positive effects will contribute to enhanced economic efficiency and competitiveness and thus give effect to the Lisbon strategy goals in this important sector.

## Annex: Condensed overview of the IA analysis

(Preferred options are marked in bold)

Available options	Impact on:		In favour of? :
	Investor's protection	Efficiency	Market integration
<b>Notification</b>			
Ex-ante verification (of marketing arrangements)	+	-	no
<b>On-going ex-post controls</b>	+/ $\approx$	+	yes
<b>Fund mergers</b>			
<b>Information only to disappearing fund's investors</b>	-	+	yes
<b>Information to all investors<sup>1</sup></b>	+	-	no
<b>Entity pooling</b>			
Allow entity pooling in a broad sense	-	+/-	yes
<b>Allow master-feeder structures</b>	+	+	yes
<b>Management Company Passport (MCP)</b>			
<b>Do nothing<sup>2</sup></b>	+/-	-	no
MCP for corporate and contractual funds	--	$\approx$	yes
Make the MCP for corporate funds work	-	-	yes
<b>Simplified Prospectus</b>			
KII provided in the form of building blocks	+/-	-	no
<b>KII provided as a single stand-alone document</b>	+	+	yes

<sup>1</sup> Only in certain cases

<sup>2</sup> Even if this option does not seem clearly superior, the analysis has identified important feasibility concerns regarding the other two.

Assessment: '+' = positive; '-' = negative;  $\approx$  = neutral